

PART I

OVERVIEW OF THE WASHINGTON TAX SYSTEM

State and Local Government Revenues

According to the latest survey data compiled by the Census Bureau of the U.S. Department of Commerce, total revenues received by Washington state and local jurisdictions amounted to \$42.1 billion during fiscal year 2002 (see Table 1).

"General" revenues accounted for 86 percent of the total Washington revenues. The expenditure of these revenues is typically determined by the legislative bodies of the various governmental jurisdictions (State Legislature, County Commissioners, City Councils, etc.) via the annual or biennial budget process. Taxes are the most important of the general revenue sources for the state and second to intergovernmental revenues for local governments; they represent 46 percent of total revenues. Other significant revenue sources are charges for services and federal grants; each account for about 17 percent of total revenues. Intergovernmental transfers, including state-shared tax revenues, are especially important for local jurisdictions.

Nongeneral revenue sources represent the remaining 14 percent of total revenues; these revenues are usually not available for general programs but are often dedicated to specific purposes. Examples include enterprise funds received for municipal utility functions, profits derived from liquor sales, payroll taxes that are dedicated for workers' compensation programs, and employee contributions for pensions.

Taxes can be defined as compulsory payments to a governmental entity in which the amount paid is not directly related to the cost of or benefits received from a service provided by the public jurisdiction. Examples of items which are directly related to a specific service and which are not considered as general taxes include benefit assessments for local improvement districts and payroll taxes levied upon employers for compensation to unemployed or injured workers.

The Census Bureau figures indicate that Washington state and local taxes totaled \$19.5 billion for fiscal year 2002. By far the largest source was the general sales and gross receipts tax category, which represented 47.3 percent of all state and local taxes in Washington. In addition to the state and local retail sales/use taxes, this category includes the state business and occupation tax and municipal business taxes since they are generally based on gross sales. (Few other states levy taxes measured by gross receipts, so the Census Bureau includes these in the general sales tax category.) The property tax was Washington's second largest tax source representing 29.7 percent of all state and local taxes; it remains the most important local revenue source, accounting for 62.9 percent of all local tax receipts.

TABLE 1
REVENUE OF STATE AND LOCAL GOVERNMENTS IN WASHINGTON¹
Fiscal Year 2002 (Dollars in Millions)

<u>Source of Revenue</u>	<u>State Level</u>	<u>Local Level</u>	<u>Total</u>
Taxes:			
Property taxes	\$ 1,457.4	\$ 4,333.1	\$ 5,790.6
General sales taxes ²	7,904.0	1,327.3	9,231.3
Motor fuel taxes	742.7	-.-	742.7
Liquor taxes	174.2	-.-	174.2
Tobacco taxes	330.7	-.-	330.7
Utility taxes	332.4	402.6	735.0
Other sales taxes	465.8	295.8	761.6
Vehicle license taxes	308.5	29.2	337.7
Other taxes	912.8	496.9	1,409.7
Subtotal	12,628.6	6,884.9	19,513.5
Current Charges:			
Education	1,530.4	269.1	1,799.5
Hospitals	446.1	1,088.3	1,534.4
Sewerage/garbage	5.9	1,408.7	1,414.5
Other charges for service	370.7	1,479.7	1,850.4
Federal Grants	6,215.9	825.6	7,041.6
Intergovernmental Transfers	132.5	7,559.4	-.*
Interest Earnings	614.0	725.8	1,339.8
Other General Revenue	831.0	1,020.2	1,851.2
Non-General Revenue:			
Utility operations	-.-	4,798.3	4,798.3
Liquor store revenue	365.1	-.-	365.1
Insurance trust revenue ³	672.9	(57.4)	615.5
TOTAL REVENUE	\$23,813.1	\$26,002.7	\$42,123.9*

¹Source: Bureau of the Census, U.S. Department of Commerce, State and Local Government Finances, 2001-02.

²Includes gross receipts business taxes which are generally measured by sales.

³Unemployment compensation and industrial insurance receipts less employee retirement.

*Duplicate intergovernmental transfers are excluded from the total.

State taxes accounted for 65 percent of all state/local taxes in Washington; local government taxes comprised the remaining 35 percent. Washington's ratio of state taxes is higher than many states (compared with 59 percent nationally) because Washington finances a greater proportion of governmental services at the state level, particularly funding of K-12, vocational, and community college education and public assistance programs.

There are three general types of taxes: property, income, and excise. Property taxes consist of annual payments by owners of real property (land and structures) and personal property (tangible and intangible). Property taxes are measured by the value of the property (i.e., ad valorem tax) determined either by the fair market value or a statutory assessment formula.

Income taxes include the federal, state, and local taxes measured by the annual income of individuals and corporations. Washington is one of seven states that does not levy a personal income tax upon households and one of only four states – the others are Nevada, South Dakota, and Wyoming - that does not impose any form of income tax (Alaska, Florida, and Texas have corporate income taxes but not a personal income tax).

Excise taxes include virtually every other type of tax. Although there is not a single definition of excise taxes, generally these refer to a specified type of transaction or privilege. In Washington most excise taxes are measured by the selling price or some other measure of sales such as gross receipts. The retail sales tax is the single largest excise tax levied in this state. The major business tax is the business and occupation tax; although measured by gross "income," it is levied on the privilege of engaging in business and is categorized by the Census Bureau as an excise tax rather than an income tax. Other excise taxes include the selective sales taxes on specific products (cigarettes, gasoline, etc.) and the various taxes which are levied in lieu of property tax (e.g., harvested timber, leaseholds, etc.).

For more details on tax collections in various states, see the Census Bureau website: www.census.gov/govs/www/estimate.html. Also, see the final section in this chapter for comparisons of tax burdens among the states.

State Government Revenues and Expenditures

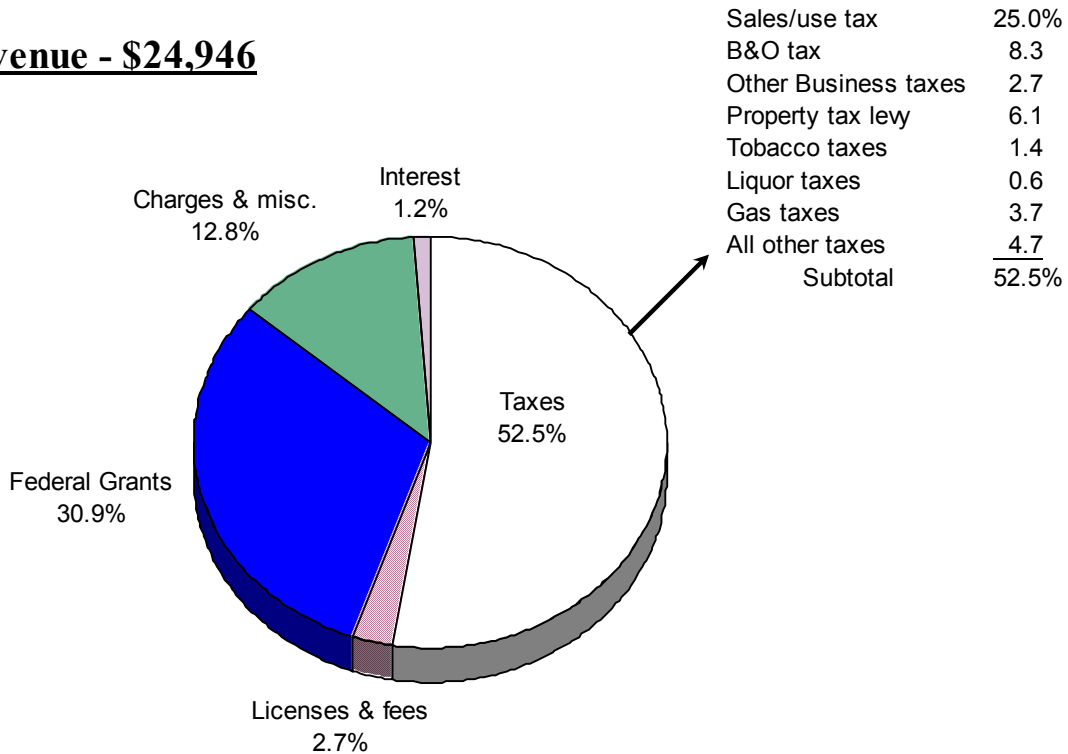
Data compiled by the Office of Financial Management (OFM) and published in its Comprehensive Annual Financial Report (CAFR) form the basis for the state revenue and expenditure information shown in the following charts; local governments are not included in these data. It should be noted that accounting differences may exist between the OFM figures indicated here and those reported by various tax collecting agencies in the remainder of this book. The first set of charts reflects the revenues and expenditures for all state government funds; the following page shows the state general fund. The general fund is the source of funding for most programs which are not funded by dedicated revenue sources. Most transportation expenditures (and the fuel taxes and federal revenues which fund transportation) are outside of the general fund. Likewise, workers' compensation programs, which provide benefits to employees who become injured or unemployed, and pension programs of public employees are financed outside of the general fund.

WASHINGTON STATE FINANCES

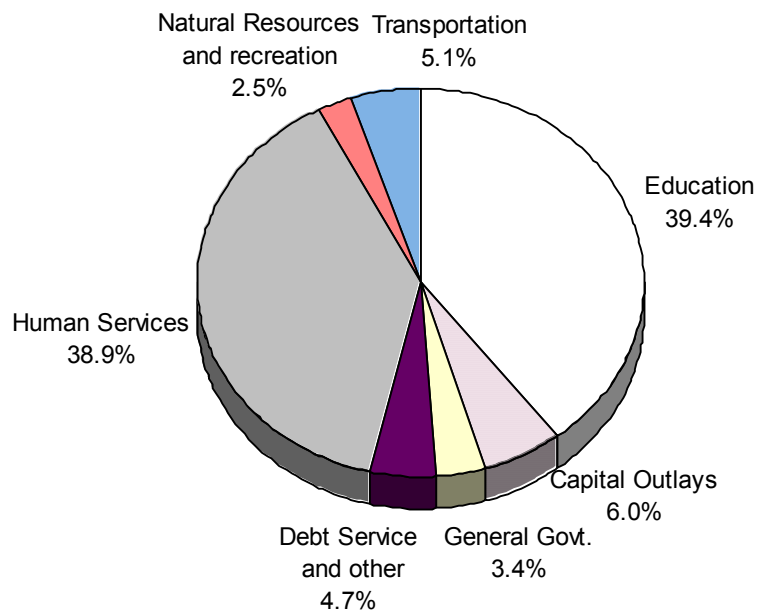
Fiscal Year 2004

All State Funds (\$ in millions)

Revenue - \$24,946



Expenditures - \$25,601

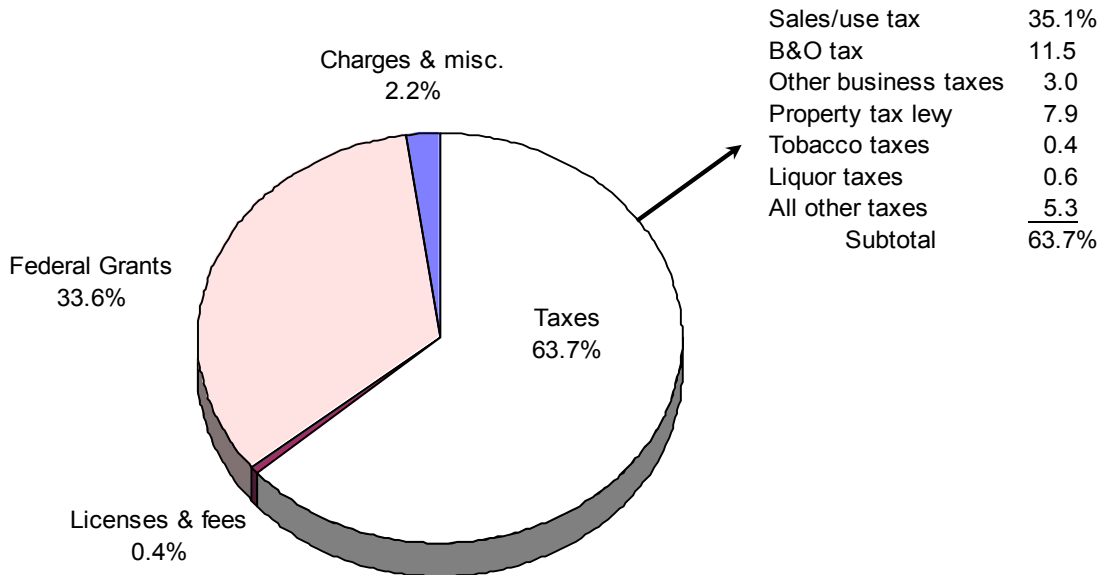


WASHINGTON STATE FINANCES

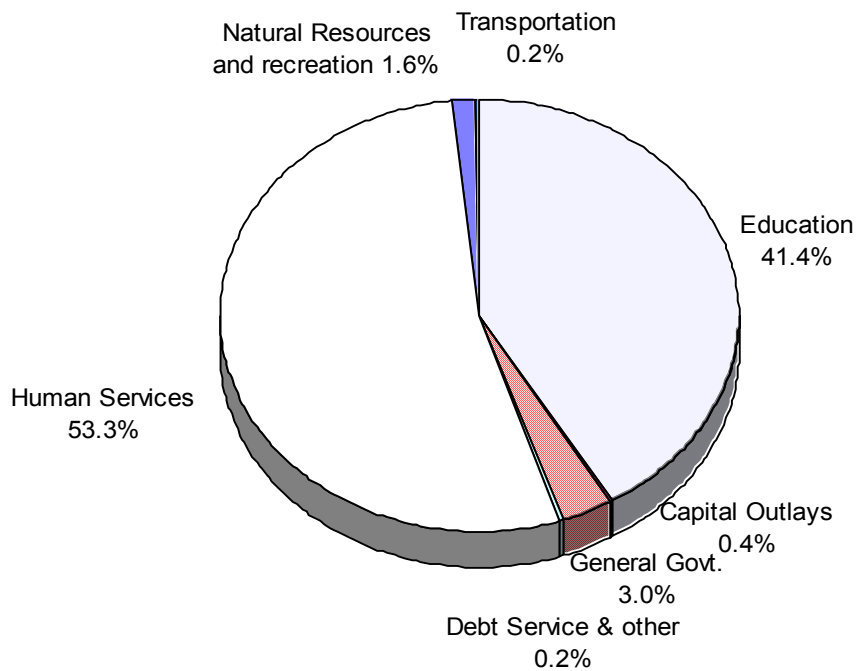
Fiscal Year 2004

State General Fund (\$ in millions)

Revenue - \$17,610



Expenditures - \$16,880



For fiscal year 2004 total state revenues for all state government funds, excluding enterprise activities, amounted to \$24.9 billion. Taxes accounted for \$13.1 billion or 52.5 percent of the total. Receipts from the federal government constitute the other major category of state revenue; federal grants equaled \$7.7 billion and represented 30.9 percent of the total. Education, including support for K-12 schools and expenditures for public colleges and universities, accounts for 39.4 percent of all state expenditures. The other major state expenditure category was for human service programs; these represented 38.9 percent of state expenditures from all funds.

Washington State's general fund revenues amounted to \$17.6 billion for fiscal year 2004. Approximately 63.8 percent of the total was attributable to tax revenues, while federal grants represented nearly one-third of all general fund revenues. Within the tax category, the retail sales/use tax represented by far the largest source, accounting for 35.1 percent of state general fund revenues. The two other major state taxes were the business and occupation tax and the state property tax levy; these produced 11.5 and 7.9 percent respectively of state general fund revenues. Human services represents 53.3 percent of general fund expenditures, while education comprises 41.3 percent of general fund programs. The cost of operating general state government programs, including most executive branch agencies, the Legislature, state judicial expenses, licensing and regulation activities, financial administration, and a variety of other general administration functions--amounted to 3 percent of general fund expenditures.

Net Washington State Tax Collections

Further detail on taxes collected for state purposes is shown in Table 2, according to information compiled by the various tax-collecting agencies. The data in this table are consistent with the amounts indicated for each particular state tax source in the body of this report; however, the figures may be slightly different than those reported by the Office of Financial Management or by the Census Bureau due to differences in definitions (e.g., the Census Bureau includes a variety of license fees as miscellaneous tax revenues) and because some of the reported revenues may be on the basis of cash collections and others may represent accrued tax liability (GAAP basis).

The total of all state taxes covered in this manual for fiscal year 2004 was \$13 billion, an increase of 7.2 percent over the fiscal year 2003 amount. As seen in Table 2, by far the largest state tax source is the retail sales tax which totaled \$5.8 billion. Together with its companion use tax, the sales/use tax represents 47.6 percent of total state tax collections. In second place was the business and occupation tax with 15.9 percent of the total. The third largest state source was the state property tax levy; it produced 11.7 percent of state tax revenues. In fourth place among state tax sources was the motor vehicle fuel tax; together with the special fuel tax the gas taxes produced about 6.8 percent of total state taxes.

TABLE 2
NET WASHINGTON STATE TAX COLLECTIONS*
Fiscal Years 2003 and 2004 (\$ in thousands)

<u>Tax Source</u>	<u>Fiscal 2003</u>	<u>Fiscal 2004</u>	<u>% Change</u>	<u>2004 % of Total</u>
General/Selective Sales Taxes				
Retail sales	\$5,560,658	\$5,791,960	4.2%	44.5%
Use	376,648	391,015	3.8	3.0
Cigarette	329,627	336,156	2.0	2.6
Tobacco products	23,637	27,393	15.9	0.2
Liquor sales	63,346	69,317	9.4	0.5
Liquor liter	70,213	73,821	5.1	0.6
Wine	17,147	17,778	3.7	0.1
Beer	29,819	30,900	3.6	0.2
Motor vehicle fuel	614,473	734,091	19.5	5.6
Special fuel	124,145	154,146	24.2	1.2
Aircraft fuel	1,727	2,281	32.1	0.0
Convention center	38,432	40,703	5.9	0.3
Solid waste collection	25,604	26,849	4.9	0.2
Wood stove	234	205	(12.4)	0.0
Brokered natural gas	23,977	24,178	0.8	0.2
Rental car	20,622	20,181	(2.1)	0.2
Enhanced 911 telephone	10,172	16,115	58.4	0.1
Telephone assistance (WTAP)	5,318	5,529	4.0	0.0
Telephone relay (TRS)	5,749	5,980	4.0	0.0
General/Selective Business Taxes				
Business & occupation	1,923,370	2,067,872	7.5	15.9
Public utility	269,821	292,831	8.5	2.3
Insurance premiums	316,689	345,614	9.1	2.7
Food fish/shellfish	1,850	1,698	(8.2)	0.0
Hazardous substance	50,721	68,921	35.9	0.5
Soft drinks syrup	9,293	17,846	92.0	0.1
Petroleum products	--	26,534	--	0.2
Oil spill	5,537	5,809	4.9	0.0
Litter	6,229	6,973	11.9	0.1
Parimutuel	1,816	1,774	(2.3)	0.0
Boxing/wrestling	231	70	(69.7)	0.0
IMR	7,952	8,269	4.0	0.1
Nursing home fee	--	32,802	--	0.3
Property & In-lieu Taxes				
State levy	1,482,680	1,524,255	2.8	11.7
Aircraft excise	275	276	0.4	0.0
Watercraft excise	12,883	13,522	5.0	0.1
Timber excise	8,327	7,855	(5.7)	0.1
PUD privilege	36,999	36,614	(1.0)	0.3
Leasehold excise	18,628	19,436	4.3	0.1
Other Taxes				
Real estate excise	513,996	615,618	19.8	4.7
Estate & transfer	122,451	139,855	14.2	1.1
TOTAL	\$12,131,296	\$13,003,042	7.2%	100.0%

Excludes local taxes and state payroll taxes for workers' compensation programs.

Initiative 601 Limit on State Expenditures and Tax Increases

In November 1993 the voters of Washington approved Initiative 601 (Chapter 43.135 RCW). This measure limits the amount which state government may spend from the general fund and also imposes a supermajority voting requirement on increases in state taxes. It replaced another limitation mechanism, Initiative 62, which was approved by the voters in 1979; this had limited the growth in state revenues to the growth rate in state personal income.

SPENDING LIMITATION

The 601 spending limitation prohibits the expenditure of state general fund revenues above a certain level that is determined by formula. The expenditure limit became effective on July 1, 1995, and therefore first impacted expenditures during fiscal year 1996. The limit is based on actual state general fund expenditures for the previous year increased by the fiscal growth factor which consists of the sum of the percentage change in state population and inflation (measured by the implicit price deflator) averaged over the three previous fiscal years. The growth factors for the two years of the current 2003-05 biennium have been determined to be 3.20 and 3.03 percent respectively; projections for the 2005-07 biennium are 2.82 and 3.09 percent for fiscal years 2006 and 2007.

Because the expenditure limit applies on a fiscal year basis, determining the amount of appropriations within the biennial state budget must now be done on an annual basis so that the limit for individual fiscal years is not exceeded. Each November, the Expenditure Limit Committee (consisting of the Director of the Office of Financial Management, the Attorney General, and the chairs of the House and Senate fiscal committees) adjusts the limit for the previous fiscal year to reflect the actual level of expenditures which occurred. It then forecasts the limit amount for succeeding years. The expenditure limits for each year of the current 2003-05 biennium and the ensuing 2005-07 biennium are shown below:

Fiscal Year 2004	\$11,452.1 million
Fiscal Year 2005	\$12,023.5 million
2003-05 Biennium	\$23,475.7 million
Fiscal Year 2006	\$12,362.6 million (projected)
Fiscal Year 2007	\$12,744.6 million (projected)
2005-07 Biennium	\$25,107.2 million

If revenues from the existing tax structure exceed the expenditure limit, the excess is deposited into an emergency reserve fund. This fund is limited to an amount equal to 5 percent of the state revenues in the general fund. If that balance is equaled, the excess funds are then transferred to an education construction fund to be used for K-12 schools and higher education construction. The emergency reserve fund may only be utilized with a two-thirds vote of both houses of the Legislature and only up to the overall expenditure limit.

The initiative requires that any shifts of revenue sources or programs into or out of the general fund will require a commensurate reduction in the expenditure limit. Likewise, it requires that local governments be compensated by the state for any new programs or expanded services they are required to perform by the Legislature. If program responsibility is shifted to or from the state to local jurisdictions or the federal government, the state expenditure limit shall be changed accordingly.

VOTING REQUIREMENTS FOR TAX INCREASES

Initiative 601 also limits the manner in which state revenue may be increased. After July 1, 1995, any measure which increases state revenues or results in revenue-neutral tax shifts may only be adopted if two-thirds of the members of both houses of the Legislature approve. Further, the increased revenues must not result in expenditures above the spending limit. If the additional revenues will cause the limit to be exceeded, then the measure must also be approved by a simple majority vote of the statewide electorate. The initiative allows temporary tax increases to combat the effects of natural disasters for up to 24 months upon declaration of an emergency by the Governor and a two-thirds vote of the Legislature; no referral to the voters is required for such emergencies.

Comparisons with Other States

No other state relies so heavily on sales taxes as does Washington. The reliance on general sales taxes in Washington is nearly twice the national average: 47.3 percent versus 24.6 percent. (The Census Bureau includes Washington's B&O tax in the general sales category, since it is measured by gross sales.) Including taxes on the sale of specific goods, the overall general sales tax category accounts for 61.4 percent of state and local taxes in Washington. Balancing the heavy reliance on sales taxes is the absence of an individual or corporate net income tax, which produces an average of 25.5 percent of total tax revenues in other states. Property taxes represent 29.7 percent of total taxes in Washington; this is slightly less than the national average reliance of 30.9 percent.

Table 3 illustrates the utilization of major state and local tax sources in Washington compared with the national average for the latest year that comparable data are available.

There are two principal methods for measuring tax burdens among the states. The first simply divides the total tax collections by the population of a state to obtain a per capita figure. (The calculation usually includes taxes paid by businesses, since it is not possible to separately identify business tax payments for all tax sources; in any case these are often assumed to be passed on to individual consumers.) Based on the latest available data (fiscal year 2002), Washington state and local taxes per capita amounted to \$3,216. This statistic ranked 16th from the highest among all states in tax burden and was 2.1 percent above the national average of \$3,149.

TABLE 3
PERCENTAGE RELIANCE ON MAJOR STATE/LOCAL TAXES
Washington State and National Average
Fiscal Year 2002

<u>Tax Source</u>	<u>Washington</u>	<u>All States</u>
General sales taxes*	47.3%	24.6%
Selective sales taxes	14.1	11.2
Property taxes	29.7	30.9
Income taxes	-.-	25.5
All other taxes	8.9	7.8
TOTAL	100.0%	100.0%

*includes retail sales/use and gross receipts taxes.

Source: State and Local Government Finances in 2001-02, Bureau of the Census.

However, because there are significant differences among individual residents of the state, the per capita method only produces meaningful data for persons who are "average" in terms of income and other relevant criteria such as age, family size, geographical location, etc. For example, the household tax burden for a very large family may not simply be the statewide per capita amount multiplied by the number of persons in the family, since the tax burden attributable to children is likely somewhat lower than for adults. Likewise, actual taxes might be higher for persons during their household formation years (making purchases of a residence, household goods, etc.) than in retirement years. Further, there are significant differences in personal income among states, and hence they do not all have the same ability to finance government services.

Washington's tax system is driven largely by consumption and consumption depends most directly upon income. Thus, comparing tax burdens to income yields a more representative tax burden indicator for most households. Total tax collections divided by a state's aggregate personal income (a statistic developed by the Bureau of Economic Analysis of the U.S. Department of Commerce) produces such a comparison. In fiscal year 2002 Washington's state and local taxes amounted to \$100.90 per \$1,000 of personal income. This compared with the national average of \$103.98 and ranked 32nd from the highest in overall tax burden.

Table 4 provides a recent history of Washington's comparative tax burden. The table shows that tax burdens were relatively lower during the early 1980s as the recession impacted Washington more severely than many states. The income comparison indicates that Washington tax burdens reached an all-time low in 1981, when state and local taxes were higher in 38 other states. Tax burdens returned to more typical levels during the remainder of the decade, as Washington's economy rebounded relative to other states and per capita personal income returned to previous levels. During most of the 1990s the tax rankings for Washington were at all-time high levels, ranking as high as 9th by the income measure and 10th on the per capita basis. In the latest several years Washington's tax ranking have moderated, due to the repeal of tax increases enacted in 1993, the impact of Initiative

601 in restraining state expenditure growth, adoption of Referendum 47 which has restrained the growth in property taxes, and repeal of the motor vehicle excise tax. In fact, the tax burden in relation to income (\$100.90) is now at the second lowest level in the past 40 years.

TABLE 4
WASHINGTON TAX BURDEN SINCE 1980
State/Local Taxes in Relation to Population and Personal Income

<u>Fiscal Year</u>	<u>Taxes Per Capita</u>		<u>Taxes Per \$1,000 Income</u>	
	Amount	Rank	Amount	Rank
2002	\$3,216	16	\$100.90	32
2001*	n.a.	n.a.	n.a.	n.a.
2000	3,178	15	107.53	32
1999	3,148	13	111.25	20
1998	3,038	13	115.00	17
1997	2,916	11	117.49	11
1996	2,795	10	119.79	12
1995	2,728	10	123.00	11
1994	2,596	10	121.24	15
1993	2,433	10	117.95	17
1992	2,326	12	122.17	11
1991	2,236	11	121.75	9
1990	2,123	11	122.98	10
1989	1,910	15	118.76	16
1988	1,783	17	117.04	16
1987	1,697	15	114.99	19
1986	1,589	14	113.89	16
1985	1,435	18	108.47	25
1984	1,416	13	112.85	21
1983	1,306	13	109.22	16
1982	1,172	20	101.80	34
1981	1,037	21	100.45	39
1980	989	19	108.75	28

*The Census Bureau did not compile figures for local governments in FY 2001.

Source: State and Local Government Finances, Bureau of the Census, U. S. Department of Commerce.